“Corporate governance and financial performance in Islamic banks: the role of the sharia supervisory board in multiple-layer management”

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CORPORATE GOVERNANCE AND FINANCIAL PERFORMANCE IN ISLAMIC BANKS: THE ROLE OF THE SHARIA SUPERVISORY BOARD IN MULTIPLE-LAYER MANAGEMENT

Abstract

This study aims to investigate the impact of Good Corporate Governance (GCG) on the financial performance of sharia banking. GCG is measured by the Board of Commissioners Performance, the Board of Commissioners Composition, the Number of Audit Committees, the Board of Directors, and the Sharia Supervisory Board Performance, whereas financial performance is proxied by Return on Assets, financing risk (Non-Performing Financing), and capital (Capital Adequacy Ratio). Sharia commercial banks registered by Bank Indonesia made the sample of this study. Annual reports and GCG reports of sharia commercial banks from 2014 to 2017 are used as a data source. The study uses a panel data regression approach to analyze the data; some interesting results have been obtained. The Sharia board positively affected financial performance of Islamic banks in terms of return on assets and capital adequacy ratio, and negatively as to non-performing financing. Similarly, the board of directors had a significant impact on the financial performance of Islamic banks in the same direction as the sharia supervisory board in terms of the three components. Meanwhile, the board of commissioners had a significant and positive impact only on the return on assets of Islamic banks in Indonesia.

Keywords sharia banking, good corporate governance, return on assets, non-performing financing, capital adequacy ratio

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INTRODUCTION

The financial crisis has broadened the enthusiasm of scientists about the link between corporate governance and the financial sector performance (Pathan & Faff, 2013), although such links are still open to debate. Numerous inquiries have not received a definite answer as to: Do the performance and the governance structure influence return on equity? What is the ideal number of executives? (Mollah & Zaman, 2015). Previous studies argued that since the connection between corporate governance and companies' performance is perplexing (Ur Rehman & Mangla, 2010), the impact of good corporate governance (GCG) on financial performance has been uncertain.

Meanwhile, in line with the development of sharia business, Islamic banking in Indonesia has grown rapidly (Dewany, 2015). The growing number of the public involved in sharia-based economic activities has led Islamic banking to provide banking services to its customers in accordance with sharia principles. The main principles of Islamic banks, as revealed by Beck, Demirguc-Kunt, and Merrouche (2013),

prohibited the introduction of interest payments (riba) and do not allow speculation. The profit or loss of an Islamic bank is based on the risk-sharing model.

The unique aspect that differentiates between Islamic banks and conventional banks in running their business is that Islamic banks have a Sharia Supervisory Board (SSB) as the main feature of their governance. The SSB is a significant component of Islamic banks and is considered a "Supra Authority" (Choudhury & Hoque, 2006). The SSB serves as an extra layer of the governance, together with the board of commissioners, the board of directors, and other operational committees. In this manner, the SSB changes the governance of Islamic banks into what is called multi-layer governance. This is in contrast to a single-layer governance structure, which typically consists of a broad of directors and an executive subcommittee in conventional banks (Mollah & Zaman, 2015).

A number of studies on Good Corporate Governance (GCG) using conventional banks as research objects have been conducted; however, research on GCG in Islamic banking is still limited. Besides, in the case of Islamic banking in Indonesia, the effective implementation of new GCG began in 2010 and is relatively new. There are only a few studies that have used Islamic banking as a research object.

Therefore, this study can contribute to the literature on the role of GCG in determining the financial performance of Islamic banks, since most of the previous research, such as Pathan and Faff (2013), Ekaputri (2014), Permatasari and Novitasary (2014), Dewany (2015), and Wahyudin and Solikhah (2017), do not deal with the component of Corporate Governance, but use a composite index obtained from the bank's personal assessment. This research tries to apply specific components of Corporate Governance, such as the Performance of Board of Commissioners, the Composition of Board of Commissioners, and the number of Audit Committee, the number of Board of Directors, and the performance Sharia Supervisory Board to the financial performance of Islamic banking.

Using different models, this study also investigates the implementation of more complete Corporate Governance of financial performance, while previous research estimated only the implementation of GCG of the financial performance in terms of Return on Assets (ROA) or Return on Equity (ROE). This study attempts to analyze the influence of Corporate Governance component on overall financial performance, including Rate of Return measured by Return on Assets (ROA), Financing Risk measured by Non-Performing Financing (NPF), and capital level measured by the Capital Adequacy Ratio (CAR).

The next section of this paper discusses a review of the literature on the topic discussed and the hypothesis formulation. Then, the data and research methods used in this paper are explained, followed by the results of the analysis. The last section summarizes, concludes and suggests the potential findings for future research.

1. LITERATURE REVIEW

As the focus of this study is the impact of three components of Islamic bank governance (sharia supervision, the board of directors, and commissioners) on the bank financial performance, this segment quickly reviewed the important literature. The review was restricted to issues identified in the hypotheses about the relationship between company's performance and (i) the Sharia Supervisory Board (SSB), (ii) the Board of Directors, and (iii) the Board of Commissioners. The discussion began with the grand theory for good corporate governance (agency theory), followed by a discourse on every dimension.

1.1. Agency theory

Corporate governance is a well-known subject of research due to its extraordinary impact on companies. Research issues that are relevant and more specific to the GCG components, for example, shareholders, board of directors, the executive's compensation, and corporate governance policies,

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are broadly investigated in late scientific articles such as Bebchuk and Weisbach (2010), who comprehensively explain the above component of the financial performance.

This study uses agency theory to explain the role of GCG implementation on financial performance (Jensen & Meckling, 1976; Fama & Jensen, 1983). According to Jansen and Meckling (1976), the concept of agency theory is based on problems arising when company management is separated from its owner. A company is a mechanism that provides opportunities to stakeholders, contributing to capital, expertise, and labor, to maximize long-term profits. As a result, multiple ownership can become a challenge for companies caused by the lack of motivating forces to control asset management (Grossman & Hart, 1986), which can further lead to new problems. Meisser, Glover, and Prawitt (2006, p. 7) state that agency relations (principals and agents) give rise to two problems, namely:

a) the occurrence of asymmetric information (information asymmetry), when management generally has more information about actual financial position and position of the business owner; and

b) the occurrence of conflict of interest due to unequal objectives, when management does not always act in accordance with the owner's interests seeking personal benefits, usually performed by an agent.

1.2. GCG and financial performance

Various studies revealed a positive effect of corporate governance on the value of firms (e.g., Lee, Rosenstein, Rangan, & Davidson III, 1992). Be that as it may, Hutchinson (2002) found a negative relationship between corporate governance and company value; while, Gupta, Kenndy, and Weaver (2009) demonstrated no proof that corporate governance impacts company value.

Despite the fact that a thorough written study of the impact of corporate governance on banking sector performance was not very large, however, as this research focused on the relations within the banking sector, especially those related to Islamic banking, it was essential to the literature on this issue in a nutshell. The latest literature on Islamic banks consists, for example, of studies by Abedifar, Molyneux, and Tarazi (2013), who stated that basically, Islamic banks face additional risks due to the complexity of the Islamic finance model. As a result, sharia supervision, in which this mandate is carried out by the sharia supervisory board (SSB), plays an important role in the business operations of the Islamic banks.

The effect of the implementing GCG in Islamic banking is still inconclusive. Syam and Nadja (2012) proved that the quality of the implementation of GCG does not affect the rate of return, yet it has a negative effect on the risk of financing in Islamic banks in Indonesia. Ekaputri (2014) also argued that the implementation of GCG can reduce the risk of financing. However, Dewany (2015) suggested that the implementation of GCG does not affect the rate of return or the risk of the financing of the Islamic banks, but it has a positive effect on the level of capital of Islamic banks. Interestingly, that finding was contradictory to one of the previous studies conducted by Khan and Bhatti (2010) that GCG did not affect CAR.

The important point of previous studies to be emphasized was that most of them used independent variables of Good Corporate Governance in the form of a composite index, which is not a specific component of the GCG. Therefore, to analyze the real effect of the GCG component, this study used special component variables of the three-dimensional corporate governance of the Islamic banks.

1.3. The Sharia Supervisory Board and financial performance

The extraordinary development of the Islamic banking and finance has progressed in most Muslim nations, and additionally in western nations (most of the non-Muslims) (Khan & Bhatti, 2010). According to Safieddine (2009), the existence and operation of Islamic banks, theoretically differ from those of conventional banks in terms of their commitment to social equity. To add to the accomplishment of social equity, Islamic banks shall comply with Islamic rules. The main feature of Islamic banks is the institution of the Sharia Supervisory Board (SSB) with its function to help ensure the operational compliance

of Islamic banks with sharia principles. The roles and responsibilities of the SSB, in general, are to advise the board of directors; to provide input to sharia financial institutions on the issue of sharia in order for the companies to comply with the sharia principles; to establish rules and principles regarding sharia products; to watch the compliance and guarantee policies and systems that are arranged by sharia institutions according to sharia principles and to issue decisions (fatwas) with the aim to create trust in sharia principles. Moreover, Hayat and Malik (2014) stated that the fundamental distinction between conventional banks and Islamic banks in terms of governance is the ethical foundation and the presence of a sharia supervisory board. Given this explanation, the following hypothesis is formulated:

H1: The Sharia Supervisory Board significantly influences the financial performance of Islamic banks in terms of ROA, NPF, and CAR.

1.4. The Board of Commissioners and financial performance

The major function of the board of commissioners was to conduct monitoring that closely related to agency theory. According to this theory, the board of commissioners takes the responsibility to supervise management on behalf of the shareholders to avoid conflicts of interest between the principal and the agent (Lefort & Urzúa, 2008). When performing its functions, the board of commissioners is responsible for improving the company reputation, building external relations, and providing advice to the management (Zahra & Pearce II, 1989).

Agency theory explained that the controlling shareholder or representative joined the management of the company to avoid agency costs arising from the interests of the owners and/or the managers. Furthermore, to get its independence, the board of commissioners requires an independent party not related to shareholders, namely independent commissioners. However, Chugh, Meador, and Kumar (2011) in their study in India noted that the high proportion of the independent commissioners indicated an excessive board autonomy that could reduce the company's profitability. In line with this finding, the pieces of the literature suggested that the existence of the independent commissioners might have a positive and negative impact on company performance. Therefore, the hypothesis proposed is as follows:

H2: The Board of Commissioners significantly influences the financial performance of Islamic banks in terms of ROA, NPF, and CAR.

1.5. The Board of Directors and financial performance

Experts have revealed that the structure of the directorate is a pertinent viewpoint on agency theory (Fama & Jensen, 1983), since many studies confirmed that the most efficient board of directors has a small proportion. Evans and Dion (2012) emphasized a positive link between harmony of each part of a group and group performance. Another argument is strategic management, since large numbers of directors limit the ability of the members to initiate strategic interactions (Goodstein, Gautam, & Boeker, 1994). However, the relationship between board composition and the company's financial performance has not been conclusive. Some researchers found an insignificant relationship. Thus D. Dalton and C. Dalton (2011) stated that there was almost no evidence related to the company's financial performance about one of the fundamental elements of the corporate governance structure.

The connection between the board and financial performance has been considered using an assortment of observational and information draws. Post and Byron (2015), who inspected the connection between gender of the board members and financial performance, concluded that female directors were positively related to the company's financial performance. Other researchers, such as Conyon (2014), using dimensions of compensation for directors, and Bear, Rahman, and Post (2010) emphasized social responsibility in their research. Thus, the following hypothesis is proposed:

H3: The Board of Directors significantly influences the financial performance of Islamic banks in terms of ROA, NPF, and CAR.

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2. DATA AND EMPIRICAL METHODS

2.1. Data

This study used panel data obtained from annual reports of 14 sharia commercial banks in Indonesia within the period of 2014 to 2017. The dependent variables in this study are as follows:

1) Rate of Return (ROA);
2) Non-Performing Financing (NPF); and
3) Capital Adequacy Ratio (CAR).

Meanwhile, the independent variables, in general, were divided into three dimensions, namely, the sharia supervisory board, the board of commissioners, and the board of directors. The sharia supervisory board (SSB) was proxied by using performance indicators of the sharia supervisory board, which were measured using the meeting intensity of the supervisory board of tahe sharia bank in one year. The indicator for the commissioner board was the same as the size of the sharia supervisory board, namely the intensity of the commissioner board meetings, in addition to the variables of the number of the independent commissioners and the number of the audit committee members. As for the board of directors, the indicator used was the number of directors in the sharia bank.

2.2. Empirical method

Data collected were analyzed using a panel data regression approach and processed via software Eviews 10. When performing panel data regression, the regression model was determined either by using a general effect model, a fixed effect model, or a random-effect model. The step to choosing the best model was conducted using the Chow test, Hausman test, and Lagrange Multiplier test. In addition, to examine the impact of GCG on the financial performance of Islamic banks, three models were applied:

$$LnROA_{it} = \alpha + \beta 1 LnSSB_{it} + \\ + \beta 2 LnBOC_{it} + \beta 3 LnIC_{it} + \\ + \beta 4 LnAC_{it} + \beta 5 LnBOD_{it} + \mu_{ti}, \quad \text{Model 1}$$

$$LnNPF_{it} = \alpha + \beta 1 LnSSB_{it} + \\ + \beta 2 LnBOC_{it} + \beta 3 LnIC_{it} + \\ + \beta 4 LnAC_{it} + \beta 5 LnBOD_{it} + \mu_{ti}, \quad \text{Model 2}$$

$$LnCAR_{it} = \alpha + \beta 1 LnSSB_{it} + \\ + \beta 2 LnBOC_{it} + \beta 3 LnIC_{it} + \\ + \beta 4 LnAC_{it} + \beta 5 LnBOD_{it} + \mu_{ti}. \quad \text{Model 3}$$

To make it more convincing, this study also used the control variable in the form of a company size proxied by the natural logarithm of the total assets and the leverage of the sharia banks measured using Debt to Asset Ratio (DAR). A detailed explanation is given in Table 1.

Table 1. Research variables

Source: Processed based on various sources.

Variable	Indicator	Measurement
Dependent variable		
Rate of return	ROA (Return on Assets)	Net profit after tax/ Total assets
Risk of financing	NPF (Non-Performing Financing)	Non-Performing Loans/ Total loans
Capital	CAR (Capital Adequacy Ratio)	Stockholder Equity/ Total Risk-Weighted Assets
Independent variable		
Sharia Supervisory Board	DPS (SSB) performance	Sum of monthly meetings within a year
Commissioner board	Performance of the board of commissioners (BOC)	Sum of monthly meetings within a year
	Composition of internal commissioners (IC)	Independent commissioners/ the number of commissioner boards
	The number of the Audit Committees (AC)	Sum of audit committees
Board of directors	The number of Board of Directors' members (BOD)	Sum of the boards of directors
Control variable		
Size	Total assets	Natural logarithm from total assets
Leverage	DAR (Debt to Asset Ratio)	Total debt/Total assets

3. RESULTS

The result has suggested that the GCG implementation significantly influences the financial performance of Islamic banks, and the sharia supervi-

Table 2. Descriptive statistics

Source: Compiled by the authors.

Measurement	ROA	NPF	CAR	SSB	BOC	AC	BOD	KI	SIZE	LEV
Mean	1.72	2.99	20.44	2.56	2.25	1.24	4.11	0.68	15.07	85.08
Median	1.64	3.18	19.99	2.48	2.25	1.10	4.00	0.67	15.88	85.72
Maximum	3.27	7.11	36.70	3.40	3.33	1.61	6.00	1.00	18.37	96.82
Minimum	0.14	0.10	11.51	1.79	1.39	1.10	2.00	0.33	8.00	75.80
Std. dev.	0.88	1.84	5.96	0.30	0.44	0.19	0.92	0.18	3.09	4.81
Skewness	0.26	0.09	0.76	0.09	0.43	0.84	–0.22	0.58	–1.23	–0.22
Kurtosis	2.10	2.26	3.48	4.73	2.88	2.18	2.24	2.63	3.13	2.82

sory board (SSB) of Islamic banks is an important dimension in conducting business operations, especially financial performance. Table 2 shows descriptive statistics of the data used in this study.

Table 3 summarizes the estimation results for all models (Models 1, 2, and 3) that were assessed using series of tests (Chow test, Hausman test, and Lagrange Multiplier test) (Gujarati & Porter, 2009). According to the results, the fixed effect model is the evaluation model most appropriate to use in this study (Models 1, 2, and 3).

Table 3 shows that GCG affected the financial performance in the form of ROA, NPF, and CAR of the Islamic banks in Indonesia. This finding is in line with that of Jensen and Meckling (1976) that companies with good governance may be progressively efficient in their operational performance. Managers work viably and effectively to reduce capital expenses and limit risks thus producing higher profits. This finding also supported the result obtained by Wahyudin and Solikhah (2017) that CG affected the company's financial performance. CG rankings of go-public companies in Indonesia affect the company's accounting-based performance, such as ROA, ROE, and EPS.

Model 1 suggested that the performance of the sharia supervisory board, the performance of the commissioner board, the composition of the board of commissioners, and the performance of the board of directors positively affected Return of Assets of sharia commercial banks in Indonesia in the period of 2014–2017. These findings are supported by Sheikh et al. (2013) who used a more complete measurement of internal GCG attributes, that GCG positively influences ROA, and by other studies such as Jackling and Johl (2009).

The findings showed that sharia banks implementing GCG, especially Corporate Governance for the three dimensions of Islamic banks, positively influenced the Rate of Return as measured by Return on Assets of the banks. ROA was used to measure the ability of a bank to generate profits from its assets. Higher ROA meant that the ratio of the bank's profitability was better in terms of the assets used. Higher ROA also showed that asset performance, when it came to net profit, which

Table 3. Estimation results for all models

Variable	Model 1		Model 2		Model 3	
Constant	2.526	0.227	–32.219	0.236	–23.884	0.057*
SSB	1.033	0.014**	–0.218	0.047**	0.022	0.016**
BOC	0.021	0.078*	–0.308	0.620	2.460	0.296
IC	1.483	0.092*	0.785	0.712	2.124	0.608
KA	0.032	0.172	0.846	0.496	3.378	0.603
BOD	0.300	0.092*	–1.057	0.001***	2.790	0.010***
Size	–0.716	0.173	3.026	0.048**	0.997	0.790
Lev	0.097	0.004**	–0.068	0.1688	–0.283	0.109
Adjusted R2	0.883		0.921		0.856	
F-statistic	10.057		11.034		8.634058	
Prob. (F stats)	0.000		0.000		0.000	

Note: * means significance at the 10 % level, ** – significance at 5%, and *** – significance at 1%. Model 1: ROA as a dependent variable; Model 2: NPF as a dependent variable; and Model 3: CAR as a dependent variable; $n = 56$.

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further increased the attractiveness of the company, in this case, Islamic banks, to investors. The increased attractiveness of a company makes it more attractive to investors as the rate of return grows (Hosen, 2017; Srouji, Halim, Lubis, & Hamdallah, 2015; Irwan, 2017; Abusharbeh, 2016; Zarrouk, Jedidia, & Moualhi, 2016).

In Model 2, the effect of GCG on NPF, the variables of the performance of the sharia supervisory board and the performance of the board of directors negatively influenced NPF. This finding suggested that the better the implementation of GCG by sharia banks, especially the performance of the sharia supervisory board (SSB) and the performance of the board of directors, the lower the risk of non-performance loans to total credit would be.

This finding contradicted the one stated that the application of GCG has no effect on the NPF level (Dewany, 2015). Other related finding to the relationship between GCG and NPF stated that NPF had a positive impact on GCG, meaning that the higher the level of the financing risk in Islamic banks, the lower the quality of the corporate governance of the Islamic bank. In other words, the higher the non-performing loans (NPF), the worse the governance of the Islamic banks (Rama & Novela, 2015). The results of this study supported the findings of Syam and Nadja (2012) who stated that the implementation of GCG had an impact on the risk of financing in Islamic banks in Indonesia, and the study of Budiman (2016) that the quality of Good Corporate Governance (GCG) had a negative effect on financing risk in Islamic banks measured by asset quality (NPF).

Model 3 showed that the capital adequacy rate (CAR) of Islamic banks in Indonesia was positively influenced by the board of directors and the sharia supervisory board. This result was in line with the one of Dewany (2015) that the GCG implementation affected the level of capital (CAR) of the sharia banks in Indonesia; while, Rama and Novela (2015) stated that capital adequacy (CAR) did not have a significant effect on the quality of Islamic bank corporate governance. This meant that the relationship between CAR and GCG implementation only occurred in one direction of GCG, which was statistically proven by the effect of CAR, but not vice versa.

The scores of R^2 adjusted in Model 1, Model 2, and Model 3 were 88%, 92%, and 85%, respectively. This suggested that the variables of SSB, BOC, IC, AC, BOD and control variables of SIZE and LEV were able to explain the 88% variation in ROA, 92% variation in NPF and 85% variation in NPF. *P*-value for *F*-statistics in Model 1, Model 2 and Model 3 was significant at the 0.01 level. That is, all variables simultaneously affect the financial performance of Islamic banks in the form of ROA, NPF, and CAR. This confirmed that the implementation of GCG significantly affected the financial performance of Islamic banks.

Given this explanation, only hypothesis 2 was not fully accepted, while hypotheses 1 and 3 were accepted. The Board of Commissioners partially affected ROA, but the NPF and CAR were not significantly affected. Meanwhile, the Sharia Supervisory Board (SSB) and the Board of Directors (BOD) could influence ROA, NPF, and CAR.

The control variables used in this study were company size and leverage. Firm size was empirically proved to positively affect NPF of Islamic banks. This study also proved that leverage affected ROA performance negatively, which meant that the higher the DAR, the less the ROA.

CONCLUSION

This paper investigated the role of corporate governance in the financial performance of Islamic banks. The principle goal of the paper was to check whether Sharia supervision, as the foundation of Islamic banking and represented by a multi-layer corporate governance model, helps Islamic banks work better. Specifically, the main purpose of this study was to explore the effects of (i) the Sharia Supervisory Board, (ii) the Board of Commissioners, and (iii) the Board of Directors on the performance of Islamic banks. The focus of this research was caused by a lack of research on the impact of Sharia supervision and corporate governance on the performance of Islamic banks.

The empirical findings confirmed that the Sharia board significantly and positively affected the financial performance of Islamic banks in terms of return on assets (as an indicator of rate of return) and capital adequacy ratio (as an indicator of capital level), and negatively influenced non-performing financing (as an indicator of risk of financing). Meanwhile, the board of directors significantly affected the financial performance of the Islamic banks in the same direction as the sharia supervisory board in terms of the three components. Further investigations concerning the conduct, activities, and impacts of the Sharia council and their contribution to the management and accountability of Islamic financial institutions are urgently needed.

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